No. 6586

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

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D. W. JOHNSTON, as Trustee in Bankruptcy of the Estate of DuPont Milling & Sales Corporation, a Bankrupt, *Appellant,* vs. JOHN P. MCLAUGHLIN, Collector of Internal Revenue, *Appellee.*	

BRIEF FOR APPELLEE.

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vs.

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BRIEF FOR APPELLEE.

STATEMENT OF THE CASE.

The amount involved in this case is small, but the principles are important, and the case is important as a precedent.

The facts appear in an Agreed Statement of Facts (Tr. p. 10), and a supplement to the Agreed Statement (Tr. p. 14). The appellant will be referred to herein as plaintiff and the appellee as defendant.

It has been stipulated that during 1927 the DuPont Milling & Sales Company suffered a loss; that under the direction of its president, who controlled the majority of the stock, its books were kept in such manner as to conceal the loss from those stockholders, directors and creditors who were not acting in aid of him. It has been stipulated that for this purpose the Company's income tax return for 1927 was made out to show a profit, and the tax shown to be due on the return was paid to defendant collector.

The books of the company were audited by an Internal Revenue Agent, and the return was approved, in ignorance of the truth. The Commissioner, also in ignorance that the facts were other than as they appeared in the company's books and its tax return, made a contract with the DuPont Milling & Sales Company, by which an agreement was made between them as to a final determination of the company's tax liability for 1927. This agreement was approved by the Secretary of the Treasury (see Exhibits "B" and "C" attached to Agreed Statement of Facts, Tr. pp. 31, 34). It is stipulated that the defendant, the Collector of the tax, accepted it with no knowledge of the facts other than as they appeared in the return. The answer pleads affirmatively as a defense the agreement made between the Commissioner and the DuPont Company. The trustee in bankruptcy for the DuPont Milling & Sales Company sues to recover the tax paid under these circumstances.

The question for the court is one of law, namely, what effect shall be given to this contract? The statute permits that the agreement be set aside by a showing of "fraud". But "fraud" in what respect? Fraud in making the return? Or fraud in making the agreement? Fraud practiced upon whom and by whom?

ARGUMENT.

(1) The statute upon closing agreements.

The affirmative defense relies on Section 606 of the Revenue Act of 1928, which reads:

> "*Closing Agreements.*
>
> "(a) *Authorization.* The Commissioner (or any officer or employee of the Bureau of Internal Revenue, including the field service, authorized in writing by the Commissioner) is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal-revenue tax for any taxable period ending prior to the date of the agreement.
>
> "(b) *Finality of Agreements.* If such agreement is approved by the Secretary or the Undersecretary, within such time as may be stated in such agreement, or later agreed to, such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact—
>
> "(1) the case shall not be reopened as to the matters agreed upon or the agreement modified, by any officer, employee, or agent of the United States, and

"(2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded. (May 29, 1928, 8:00 a.m., c. 852, Sec. 606 (a-b), 45 Stat.)"

This section resembles Section 1106(b) of the Act of 1926 which reads:

"If after a determination and assessment in any case the taxpayer has paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify or set aside such determination or assessment shall be entertained by any court of the United States."

(2) Cases upon closing agreements as to tax liability.

The question has arisen several times as to the binding effect of such closing agreements.

Bankers' Reserve Life Co. v. United States, 42 Fed. (2d) 313 (Court of Claims).

Plaintiff paid income taxes for 1924 in the sum of $27,727.71. In determining the tax, the Commissioner assessed and the plaintiff paid it under the theory that a certain principle of law regarding the inclusion of tax exempt securities applied. Thereafter, and on February 25, 1928, the taxpayer and the Commissioner, with the approval of the Secretary, executed an agreement as to the final determination and assessment of the correctness of the tax paid. (This agreement was made under Section 1106 of the Act of 1926 quoted above.) At the time this agreement was made, a case was pending in the Supreme Court which involved the computation of such a tax and inclusion of such interest. Thereafter the Supreme Court rendered a decision the effect of which would (in the absence of such an agreement) have been to entitle plaintiff to a refund. Plaintiff filed claim, and on rejection, filed suit. A demurrer to the complaint was sustained.

> "The purpose of the statute in providing for closing agreements was to enable the taxpayer and the government *finally and completely* to settle all controversies in respect of the tax liability for a particular year or years and to protect the taxpayer against a further demand by the reopening of a case as a result of a different view of the matter being taken by the government officers or as the result of subsequent court decisions prior to the expiration of the statute of limitations, and to prevent the filing of additional claims for refund or the institution of suit by the taxpayer for

the same reason." (Italics ours.) Certiorari was denied. (282 U. S. 871.)

Aetna Life Insurance Co. v. Eaton, 40 Fed. (2d) 965; 43 Fed. (2d) 711 (C. C. A. 2nd Circuit).

In this action, the lower court sustained a demurrer for lack of jurisdiction. The Appellate Court reversed him on the jurisdictional question, but directed dismissal of the complaint for failure to state a cause of action. This case is like the *Bankers' Reserve Life Co. v. United States,* supra. An agreement for final determination of taxes was made in January, 1928. Under the Supreme Court's decision in June, 1928, a refund would have been due, were it not for the final agreement. It was held that the final agreement was a defense. Certiorari was denied (282 U. S. 887).

It has been held that the matter of interest upon a credit for over-payment is a part of the Commissioner's "determination" of a refund within the meaning of the term as used in Section 1106 (b) of the Revenue Act of 1926; that a closing agreement upon tax liability and the amount of a refund precludes the taxpayer from claiming that interest on the refund accrues prior to the agreement; and that the Court of Claims is without jurisdiction to modify or annul such a closing agreement.

Parish & Bingham Corporation v. U. S., 44 Fed. (2d) 993;

Lloyd Smith v. U. S., 44 Fed. (2d) 990.

The next case enjoys the favor of both appellant and appellee.

Carter Music Co. v. Bass, Collector, etc., 20 Fed. (2d) 390.

In this case an agreement was made, but was shown to have been made and procured under a misrepresentation of fact by the defendant. Held, the agreement was not a defense. Appellant appears to rely on this case as fully determinative of the case at bar (Appellant's Brief p. 7). Not so. There is not the slightest suggestion in the Agreed Statement of Facts that there was any misrepresentation by the defendant or by the Commissioner or by any agent of either of them.

(3) Rule of Construction: the terms "fraud", "malfeasance" and "misrepresentations" as used in the statute, should relate to the subject matter of the statute, the closing agreement.

The statute uses the word "fraud" in conjunction with "malfeasance" and "misrepresentation of a material fact". Malfeasance is a word of very general meaning; but misrepresentation of a material fact has a more specific meaning. We think it clear that these three causes for setting aside the final determination provided in the statute ought to be subject to the same basic rule of construction. If one of these terms must be construed to relate to things done between the parties, then all of them should be so construed.

This is a statute of repose. If this purpose is to be advanced, the only sensible construction of the words "fraud", "malfeasance" or "misrepresentation of a material fact" is that there shall be fraud, misrepresentation of fact, etc., between the parties to the agreement in the making of the agreement. If they are construed to apply to some other person, not a party to the agreement, or that it might relate to a misrepresentation, fraud by one of the parties, but not in connection with the agreement, the purpose of the statute would be avoided. To illustrate: let us suppose that the taxpayer's bookkeepers grossly overstate the net income shown in the books for the purpose of getting a larger Christmas bonus. This is a misrepresentation of a material fact upon which he relies. Upon such a showing, ought the taxpayer to be allowed to set aside his final agreement with the Commissioner? Supposing in the calculation of the taxable income the taxpayer's accountant, for private reasons of his own (let us say, revenge) miscalculates the taxpayer's invested capital, and, relying upon his audit, the taxpayer makes his agreement with the Commissioner. Ought this to be sufficient cause for the taxpayer to set aside his agreement with the Commissioner? The facts were certainly misrepresented to him, though not by the Commissioner.

If the taxpayer may set the agreement aside because of misrepresentation of fact made to him by his own employees, then the Commissioner should have the same privilege. Suppose the Revenue Agent auditing the taxpayer's account, anticipates starting in business for himself, and because of such motive, and the hope of making a friend, reduces the taxpayer's tax liability, the taxpayer himself being innocent of wrong. The Commissioner relies on his audit, pays a refund and enters into an agreement as to final liability. Would the purpose of the statute be served if the Commissioner is allowed to set aside an agreement made under such circumstances? In substance, such a construction of the statute would mean that either party, after making a final determination as provided by the statute, can say: "Hold! My agent was a rascal and I was deceived by him. Let us, therefore, set aside the agreement." This means that neither can have any real reliance upon such an agreement because neither can know all the motives and circumstances which led the other to enter into the agreement.

On the other hand if the terms "fraud", "malfeasance" or "misrepresentation", as used in the statute, are limited to the subject matter of the statute, namely, the determination made between the parties, then it would follow that it is only "fraud", "malfeasance" or "misrepresentation" *between the parties* to the agreement which will be ground for rescinding the agreement. Such a construction of the statute is comparatively simple.

The meaning of fraud in this context is well defined.

> "The essential element of fraud that must exist in any case properly brought within that desig-

> nation *is a mistake of one party as to a material fact induced by the other in order that it might be acted upon,* or (in cases where there is a duty of disclosure) at least taken advantage of with knowledge of its falsity to secure action. Generally all of the requirements of an action of deceit will be found to exist." *Williston on Contracts,* Vol. III, Sec. 1487.

Williston then goes on to state the elements of an action for deceit:

> "(1) False representations of material facts;
>
> (2) Knowledge of the falsity of the representations by the person making them;
>
> (3) Ignorance of the falsity on the part of the person to whom the representations were made;
>
> (4) Intent or at least reason to expect that the representations will be acted on by the person to whom they were made;
>
> (5) Action by such person to his damage."

If this be the legal definition of "fraud" (and we submit that it is, by all the authorities, English and American, and that Congress must be assumed to have used the word in its ordinary meaning) a definite and simple rule of construction is afforded. "Fraud", "misrepresentation of fact" and "malfeasance", which are grounds for setting aside the contract, would be limited to "fraud", "misrepresentation" and "malfeasance", which are practiced by one party to the agreement to the detriment of the other, and such "fraud", "misrepresentation" or malfeasance" must be connected in some wise with the subject matter of the agreement.

The contrary rule, for which plaintiff contends, is that there shall be no limitation upon the purpose of such "fraud", "misrepresentation" or "malfeasance", that is, such acts need not have been done by one of the parties to the agreement for the detriment of the other party, and that these grounds shall not be limited to the agreement, or even to the tax return, but may relate to things back of the tax return, for example, the keeping of the taxpayer's books, the auditing of his books, the return, itself, and lastly, the making of the agreement.

In enacting this statute, Congress undoubtedly had in mind the relief of the taxpayer. It will be remembered that there were no statute of limitations applicable to the tax liability under the early income tax acts and little or no limitation upon the power of the United States through its Internal Revenue Bureau to determine and re-determine the tax liability of its citizens. In thus providing that an agreement might be entered into, which would settle, once and for all, the liability of the taxpayer, Congress must have intended to give the taxpayer something he might rely on. If such an agreement can be overthrown only when "fraud", "malfeasance" and "misrepresentation" are shown to have existed between the parties to the agreement, a taxpayer whose conscience is free and clear of wrong-doing, can be satisfied that his liability has been finally determined. If these terms are given a broad and general meaning, not limited to the parties to the contract, and not even limited to the agreement itself, then he could have no such peace of mind.

This brings us to a consideration of the history of section 606 of the Revenue Act of 1928, which is quoted upon page 3 above.

(4) History of Section 606 of the Revenue Act of 1928.

Congress by Section 1312 of the Revenue Act of 1921 (42 Stat. 313) authorized, for the first time, the final and conclusive settlement of tax liability as between the Government and a taxpayer, said Section reading as follows:

> "FINAL DETERMINATION AND ASSESSMENT.
>
> Sec. 1312. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or

> agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States."

This section, in substance, first appeared in H. R. 8235, the Revenue Bill of 1921, as Section 1001 (Committee Print, page 270).

Later it appeared as Section 1001, Title X, page 75, in the Bill as introduced by Mr. Fordney of the House on August 15, 1921.

In the report of the Ways and Means Committee (Report No. 350, August 16, 1921), accompanying said Bill, Mr. Fordney, speaking for the Committee, said:

> "Title X, Administrative Provisions.
>
> Section 1001 would permit the taxpayer and the Commissioner to reach an agreement as to the amount of taxes due which, except upon a showing of fraud or malfeasance, would be conclusive and binding upon the parties. This provision would expedite the collection of taxes and prevent much litigation."

In the Bill as reported to the Senate the Section appeared as Section 1312, and in the Report of the Senate Committee on Finance, accompanying the Bill (Senate Report 275, page 31, Sept. 26, 1921) Mr. Penrose, speaking for the Committee, had this to say:

> "Final Determination of Taxes.
>
> Section 1312 authorizes the Commissioner of Internal Revenue, with the approval of the Sec-

retary of the Treasury and with the consent of the taxpayer, to reach a final settlement in tax cases which shall not be reopened or modified by any officer, employee, or agent of the United States, and which shall not be annulled or set aside by any court of the United States.

Under the present method of procedure a taxpayer never knows when he is through, as a tax case may be opened at any time because of a change in ruling by the Treasury Department. It is believed that this provision will tend to promote expedition in the handling of tax cases and certainty in tax adjustment. Your committee, therefore, recommends its adoption."

In the Revenue Act of 1924, the Section relating to "Final determinations and assessments" appears as Section 1006 (43 Stat. 340). The language of this Section is substantially identical with that of Section 1312 of the Revenue Act of 1921; the only change made providing that such final agreements of settlement might be made whether or not the taxes in question were paid under protest.

This Section appears in H. R. 6715, Revenue Bill of 1924, as Section 1006, and Mr. Green of the Committee on Ways and Means in Report No. 179 accompanying the Bill, and speaking for the Committee, has this to say of said Section 1006, at page 33:

"This section reenacts the provisions of Section 1312 of the existing law, with the omission of the requirement that such final determination and assessment, in cases in which the tax or penalty was paid in whole, shall only be made if it was paid without protest. Since the payment of the tax with or without protest does not necessarily affect the desirability of making such a final agreement, it is desirable to eliminate the words 'without protest' from the section."

Section 1106 (b) of the Revenue Act of 1926, quoted on page 4 above, was a reenactment, without change, of Section 1006 of the Revenue Act of 1924, and Section 1106 (b) of the Revenue Act of 1926 was in substance reenacted by Section 606 of the Revenue Act of 1928 (45 Stat. 874). For convenience, we will quote Section 606 again.

"SEC. 606. CLOSING AGREEMENTS

(a) *Authorization.*—The Commissioner (or any officer or employee of the Bureau of Internal Revenue, including the field service, authorized in writing by the Commissioner) is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal-revenue tax for any taxable period ending prior to the date of the agreement.

(b) *Finality of agreements.*—If such agreement is approved by the Secretary, or the Undersecretary, within such time as may be stated in such agreement, or later agreed to, such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact—

(1) the case shall not be reopened as to the matters agreed upon or the agreement modi-

fied, by any officer, employee, or agent of the United States, and

(2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

(c) Section 1106 (b) of the Revenue Act of 1926 is repealed, effective on the expiration of 30 days after the enactment of this Act, but such repeal shall not affect any agreement made before such repeal takes effect."

It will be noted that Section 606 is broader than Section 1106 of the Revenue Act of 1926, but that Section 606 (b) as to the finality of such agreements is substantially identical with said Section 1106 (b).

The Report of the Ways and Means Committee on the Revenue Bill of 1928, later the Revenue Act of 1928 (Report No. 2, page 32), contains the following statement by Mr. Green, Chairman of said Ways and Means Committee:

"SEC. 606. CLOSING AGREEMENTS

The closing of tax cases for the earlier years is a difficult problem. Statistics recently gathered show that an abnormally large percentage of closed cases are reopened by the taxpayer or the Government. Among the causes contributing thereto are claims by taxpayers, the effect of subsequent decisions and changes in the regulations and the law. The constant reopening of closed cases must be discouraged and one of the most effective means of preventing the reopening of cases is the execution of closing agreements. Such agreements are authorized by section 1106 (b) of the Revenue Act of 1926. There are, however, a number of restrictions in that section, the practical effect of which is to delay and often to render it impossible to secure the agreement. These restrictions have been removed in section 606 of the bill. It is believed that under this section it will be possible to execute many more closing agreements than in the past."

From this history it is clear that Congress in enacting Section 606 and the kindred sections of the 1921, 1924, and 1926 Acts, intended that agreements executed in accordance with the provisions of these sections should be conclusive and binding upon the Courts, and intended to discourage the reopening of tax cases. The benefit was intended primarily for the taxpayer but both parties are within the scope and purpose of the statute.

(5) The trustee in bankruptcy stands in the shoes of the bankrupt.

The trustee in bankruptcy takes the bankrupt's estate subject to such claims and with such rights as the bankrupt has himself, subject, of course, to the powers and special rights conferred on the trustees by statute. It is hardly necessary to cite authorities for so elementary a rule.

Collier on Bankruptcy, 13th Ed. p. 1531.

(6) The principles of an account stated are applicable.

The making of a "final agreement" as to tax liability is statutory. The nearest analogy is an account stated which is formally agreed on by the parties to be correct. No principle of law can be better settled than the rule that when an account is stated and agreed on by the parties, it becomes a new contract between them, and if a suit is brought, it is not based upon the original items, but on the balance appearing in the account stated. For such a rule it is hardly necessary to cite authority.

See

Toland v. Sprague, 12 Peters 300; 9 L. Ed. 1093;

Oil Company v. Van Etten, 107 U. S. 325; 27 L. Ed. 319;

1 *Corpus Juris* 705.

It is well settled that the surrender of a doubtful claim or right is a good consideration for an account stated and that it is not open to one party to say that such a right or claim surrendered by the other subsequently proved to be invalid.

Gardner v. Watson, 170 Cal. 570.

Similarly, there is no question but that an account stated can be impeached by a showing of fraud, duress or mistake.

Gardner v. Watson, 170 Cal. 570;

1 *Corpus Juris,* 711 and 712, citing cases.

Plaintiff suggests that the defendant received this money for no valuable or other consideration (Appellant's Brief p. 11). This argument entirely overlooks the point that subsequently a contract was made respecting this money with the government *for which a valuable consideration was given.* The government at that time made a contract binding upon itself under which it could not even have opened a dispute, unless upon a showing of fraud, misrepresentation, etc. It is idle for the appellant now to say that this was not a good consideration because as the facts developed, no more taxes would have been due: the fact is that upon the facts as they then appeared, both parties surrendered a right, the government gave up all right to sue for additional taxes, and the taxpayer gave up a right to sue for a refund.

Similarly, as to the suggestion that this suit is nothing but a suit for money had and received. It is submitted that an action would not lie for money had and received where, after payment, a contract is made between the parties by which both agree that the money is due and owing, and the recipient in good faith binds himself not to ask for more. Admittedly, if fraud is practiced by one against the other, the defrauded party has a remedy against the other. But can an innocent party to such an account be subjected to suit by the guilty or by his trustee? It is contrary to all legal principles to permit it. Yet in fact, if not in form, *this is an action to set aside a contract on the ground of fraud.*

(7) The return in question was a corporate act.

Plaintiff's brief suggests that the income tax return was not a corporate act. It was signed by the President and the Treasurer of the Company, the certificate of inventory was prepared by various officers and employees of the company. Either the return was a corporate act, or no return at all was made. If no return at all was made, we are at a loss to know what standing plaintiff has to bring this suit. We think it impossible to distinguish the making of the return and the payment of the money shown to be due upon the return: either both were corporate acts, or neither was a corporate act.

CONCLUSION.

The amount involved in this case is only $1410.58. It is not in itself enough to be of great moment to either party. The principle at stake, however, is important. The statute imparting finality to agreements such as the one involved in this case was a statute of repose. It ought not to be so construed as to nullify its purpose.

Respectfully submitted,

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